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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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1. In our petition, we noted that the Second Circuit below and the Fifth Circuit in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), considered slightly different versions of the governing regulation. We nevertheless showed that the two decisions are in direct conflict because there is no meaningful distinction between the texts that the courts considered. The Government disputes this proposition. It contends that we have ignored an "obvious and highly pertinent distinction in the text of the two regulations" (Br. in Opp. 13 n.4) and it accordingly denies the existence of a circuit conflict (*id.* at 14).

The "obvious and highly pertinent distinction" on which the Government relies was the 1977 amendment revising the regulation to provide that interest expense shall be allocated "among 'all' income producing activities." Br. in Opp. 12.

But this amendment effected no substantive change whatever. The prior version of the regulation, considered by the Fifth Circuit in *Dresser*, similarly required that interest expense be properly allocated among "the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive." Treas. Reg. § 1.861-8(a) (as amended in 1975). The items of gross income specified in those six sub-sections comprised *all* categories of income listed in IRC § 861 as "income from sources within the United States." Thus, *both* versions of the regulation – the version considered by the Fifth Circuit in *Dresser* and the version considered by the Second Circuit below – required that interest expense be properly allocated among *all* income-producing activities. The substance of the two versions is thus identical; they simply use different verbal formulas to reach the same bottom line.

The Fifth Circuit in *Dresser* made clear that it saw no meaningful distinction between the two versions of the regulation at issue. Indeed, it explicitly relied on the 1977 text of the regulation – the version considered by the Second Circuit – as "illustrat[ing] the fundamental principle" on which it based its decision, namely, the "fungibility of money." *See* 911 F.2d at 1135; Pet. 9. Because the Fifth Circuit made plain that it would interpret both versions of the regulation the same way, there can be no doubt that it would decide the instant case in a manner opposite to that in which the Second Circuit decided it.

For its part, the Second Circuit below left little doubt that it regards the Fifth Circuit's interpretation of the regulation as erroneous. The Second Circuit takes *Dresser* to task for ignoring the "plain language" of the regulation and relying instead "on its own judicial version of 'economic reality.'" Pet. App. 7a-8a. And it asserts that "*Dresser's* * * * version of the 'true cost of borrowing' has no basis in the regulation"

and "does not comport with the Regulation's concept that money is fungible." Pet. App. 9a, 8a. The Government similarly describes the Fifth Circuit's decision as "misguided" (Br. in Opp. 7) and criticizes it for giving "no consideration to the 'plain text' of subparagraph (e)(2)(ii) of the 1977 regulation, which was controlling in this case." Br. in Opp. 13 n.4. In light of these criticisms of the *Dresser* opinion, the Government's denial of a circuit conflict rings extremely hollow.

2. The Government repeatedly asserts that the "plain language of the regulation" dictates the answer to the question presented here. Br. in Opp. 9, 10, 12, 13 n.4 & 14. Yet the Commissioner at trial agreed that the regulatory language was not "plain." In the Tax Court, "both parties recognize[d] that this regulation does not expressly state whether or not netting of interest is allowed." Pet. App. 23a. The Fifth Circuit in *Dresser* likewise found the regulation to be inexplicit or ambiguous. While agreeing that a literal reading of the regulation does not expressly require netting, the court observed that "the same literal reading does not preclude such an approach either." 911 F.2d at 1134-1135.

The regulation provides rules for allocation of "interest expense." Treas. Reg. § 1.861-8(e)(2)(i). The question presented – on which the Fifth and Second Circuits have reached different conclusions – is whether "interest expense" as used in this regulation means *gross* or *net* interest expense. Finding no clear answer in the text of the regulation, the Fifth Circuit considered congressional purpose, legislative history, and the economic realities of corporate borrowing in deciding that the term "interest expense" in this context is most logically interpreted to mean *net* interest expense. As the Tax Court recognized, the Commissioner's argument to the contrary "assumes its own conclusion: that interest income

should be considered separately, and not netted with interest expense." Pet. App. 25a. Thus, only by assuming what it is trying to prove can the Government assert that the "plain language of the regulation" supplies the answer to the question decided by the court of appeals.

Here, as in the court of appeals, the Government is using its mantra of the "plain language of the regulation" to disguise its unwillingness to discuss the question actually presented: whether the term "interest expense" as used in the regulation means *gross* or *net* interest expense. There is a clear division between the Fifth and Second Circuits on that question, and this Court should grant certiorari to resolve this conflict.

3. In our petition, we explained the immense practical importance of the question presented. The allocation of interest expense to domestic-source and foreign-source income affects dozens of computations under the Internal Revenue Code, most notably concerning the foreign tax credit. As the National Foreign Trade Council explains, the question presented "is of great importance to every U.S. company that does business overseas." Brief *Amicus Curiae* of the National Foreign Trade Council, Inc., at 6. A survey of 100 companies by the National Association of Manufacturers has shown that this issue is now pending in IRS audits involving tax liabilities in the range of $65 million. *See* Pet. 14. The question presented has arisen twice in the Tax Court since the instant case was decided. *See The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996); and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M. (CCH) 2451, 2465 (1996).[1] Given the nature of this question,

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[1] We do not understand the Government's assertion that the Tax Court's opinions in *Coca-Cola*, *Computervision*, and the instant case "have not considered the governing text of the amended regulation contained in 26 C.F.R. 1.861-8(e)(2)(ii) (1980)." *See* Br. in Opp. 14 n.6. That is the

its resolution will ultimately affect the tax liabilities of virtually all U.S.-based multinational corporations.

The Government does not deny that the question presented is important in a highly practical sense to orderly administration of the tax laws. However, it notes that the regulation at issue has been amended a third time, effective for years after 1987. *See* Temporary Treas. Reg. § 1.861-9T(a).[2] The Government accordingly argues that there "is no recurring administrative importance" to questions concerning the proper interpretation of the earlier versions of the regulation considered by the Fifth Circuit in *Dresser* and by the Second Circuit in this case. Br. in Opp. 14-16. In effect, the Government urges the Court to wait and see if the existing circuit conflict persists in cases involving the new temporary regulation and, if so, consider a grant of certiorari at that time.

The Government's proposal would condemn taxpayers to many years of wasteful and unnecessary litigation. The question before the Court – whether the governing regulation requires allocation of "gross" or "net" interest expense – is squarely presented by the version of the regulation at issue here. The Justice Department in this case informed the court

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version of the regulation involved here, and it was obviously "considered" by the Tax Court in this case. This same version of the regulation was also at issue in *Coca-Cola* and *Computervision*, which involved those companies' 1985-86 and 1983-84 tax years, respectively. *See Coca-Cola*, 106 T.C. at 4, 31; *Computervision*, 71 T.C.M. (CCH) at 2464.

[2] Section 7805(e) of the Code provides, in the case of regulations issued after November 20, 1988, that "[a]ny temporary regulation shall expire within 3 years after the date of [its] issuance." Temporary Regulation § 1.861-9T(a) was issued on September 9, 1988 (T.D. 8228, 1988-2 C.B. 136) and it is therefore excluded from this automatic sunset rule.

of appeals that the new temporary regulation "simply serves to clarify the Commissioner's position" and that "the concept of fungibility did not change from one iteration of the regulation to another." Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.2d 12 (2d Cir. 1997). The Second Circuit agreed that "the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and found no evidence that it "substantially changed the rules for the apportionment of interest expense." Pet. App. 12a.

For these reasons, the new temporary regulation has little impact on the legal analysis involved in deciding the question presented. The instant case thus represents a perfectly appropriate vehicle for deciding that question and resolving the circuit conflict once and for all. Unless the Court grants certiorari, the inevitable result will be years of fruitless litigation and increasing inequities among taxpayers depending on their circuit of residence.

CONCLUSION

For these reasons and those stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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